



# The Federal Report

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT

## **The Month in Washington: September, 2008**

In addition to being a month dominated by the presidential campaigns of Senator Barack Obama (D-IL) and Senator John McCain (R-AZ) and the introduction of Senator Joe Biden (D-DE) and Alaska Governor Sarah Palin as vice presidential nominees, September has seen a near meltdown of our financial markets and a series of Washington fumbles, capped off by the failure of the House to initially pass a \$700 billion bailout bill despite the backing of every significant political leader. A subsequent repackaging of the legislation by the U.S. Senate with an additional \$100 billion in various tax changes proved enough to get the bill through the House on a second attempt and signed by the President.

### **Issues and Events**

#### **Bailout Bill Rises from Defeat, Signed by President**

With the failure of Lehman Brothers, the federalization of Fannie Mae and Freddie Mac, and taxpayer bailout of AIG Insurance, all eyes turned to Washington for a solution. At the same time, skeptical and often angry taxpayers called their representatives – Congressional offices report that calls were as high as 2,000 to 1 against the plan, and the vote on passage failed 228-205 the first time the House considered it.

After the House of Representatives refused to approve the initial bailout proposal on Monday, September 29<sup>th</sup>, the Senate made some modifications to the language – chief among them an increase in the FDIC and the National Credit Union Share Insurance Fund deposit insurance limits from \$100,000 per account to \$250,000 until December 31, 2009. The Senate then took the bailout provisions and bundled them with the so-called “tax extender” legislation as part of one big omnibus package in an effort to make it more attractive to House Republicans, who wanted to see a number of expired business and energy tax breaks extended. A fix to the Alternative Minimum Tax (AMT) was also included, and the legislation (H.R. 1424) was subsequently approved by the Senate by a vote of

74 to 25 on October 1st, and then by the House, 263 to 171, on October 3<sup>rd</sup>. President Bush signed it that same day.

Under the new law, the Secretary of the Treasury is granted sweeping new powers to purchase up to \$700 billion in troubled assets from financial institutions through a new entity, the “Troubled Asset Relief Program,” or TARP. The TARP will be administered by the Treasury Department in consultation with the Board of Governors of the Federal Reserve System, the FDIC, the Comptroller of the Currency, the Director of the Office of Thrift Supervision and the Secretary of Housing and Urban Development. In a nod to House GOP demands, the Treasury Secretary is also required to create a program to guarantee troubled assets of financial institutions, establishing risk-based premiums for such guarantees sufficient to cover anticipated claims.

The new law requires that guidelines for the new program be promptly developed, and it is to be expected that TARP will initially focus on banks and other private sector institutions whose stability is at the heart of the current credit crunch.

With regard to corporate governance issues, the strict limits on executive compensation, especially so-called ‘golden parachutes,’ that were initially identified as an essential component in any bailout by many Democrats and Republicans alike, were significantly watered down in the final version of the bill. Under the new law, Treasury is to promulgate executive compensation rules governing financial institutions that sell their troubled assets as part of the new law. If assets are purchased directly, then such institutions must observe standards limiting incentives, allowing clawback and prohibiting golden parachutes. If instead Treasury buys assets at auction, an institution that has sold more than \$300 million in assets will be subject to additional taxes, including a 20% excise tax on golden parachute payments triggered by events other than retirement, and to tax deduction limits for compensation above \$500,000.

In earlier drafts of the legislation, companies that participated in the bailout would have been required to provide (1) access to the corporate proxy for the purpose of nominating and electing boards of directors to any shareholder or group of shareholders holding, in the aggregate, 3 percent or more of the equity securities of the company; and (2) an annual, non-binding “say-on-pay” vote on executive compensation.

Both of these provisions did not make it into the final law. Nevertheless, the attention that they received, and the willingness of the Congressional leadership

to include them in initial drafts of the legislation, certainly suggests that they will be on the table in 2009 as the massive job of restructuring the financial markets and their regulation begins in earnest in the new Congress.

### **Tax Writers Weigh in on PPA Regs**

Congressional tax writers from the House Ways and Means Committee and the Senate Finance Committee sent a letter to the Treasury Department about the Administration's proposals on various details of regulations for the Pension Protection Act (PPA). Signatories included Ways and Means Chairman Charles Rangel (D-NY) and Ranking Member Jim McCrery (R-LA) and Chairman Max Baucus (D-MT) of the Finance Committee and Ranking Member Chuck Grassley (R-IO), the "Big Four" of tax policy.

Of special concern was Treasury's position on end of year valuations, a particular difficulty for smaller plans. The legislators said that the rule could harm pension coverage if small plans were "forced into the difficult position of having to either (1) freeze benefit accruals for all participants as of October 1, 2008, or (2) risk disqualification of the plan by continuing benefit accruals before computing the final AFTAP (adjusted funding target attainment percentage) for the plan year....We are concerned that absent such a modification plans that use an 'end of year' valuation date could face significant hardship in their attempt to comply with Section 436 of the Code," the legislators wrote.

Legislation on more substantial issues within the PPA remains stalled, held up by unconnected items in the Senate. Time and legislative vehicles for tax bills are rapidly running out, making action on these issues less likely.

### **Congressional Roundtable on IRS Governmental Plans Initiative Held**

A Congressional Roundtable on the IRS Governmental Plans Compliance Initiative took place on September 19th. Congressman Pomeroy, a long time supporter of public plans and a member of the Ways and Means Committee, chaired the two-hour meeting, while Ways and Means Committee Chairman Charles Rangel (D-NY) joined via conference call. Minority Committee staff, as well as representatives from numerous individual Ways and Means member offices on both sides of the aisle were also in attendance.

The primary goal of the Congressional Roundtable was to discuss the IRS' initiative to gather information on, and significantly increase its audits of, governmental pension plans that was announced at an IRS Roundtable in April of this year. A key component of the IRS' plans has been a questionnaire to be

used to survey selected governmental retirement systems (first about 24 plans, and then perhaps as many as 200 to 300 more), which raised a number of concerns when it was first shared with public plan representatives in draft form in May.

Steve Miller, IRS Commissioner of Tax Exempt and Government Entities (TE/GE), began the dialogue by describing the IRS's interest in pursuing this new initiative. Gone were earlier references and justifications involving stories of funding problems in the media and "failed plans" in California. Instead, he explained that the IRS simply does not know if there are problems with what he estimated are roughly 2,600 governmental defined benefit (DB) plans serving more than 18 million people. He pointed out that few of these plans voluntarily come to the IRS for a check-up, and that given the size and importance of this community, it was his view that the IRS must ensure that government plans are complying with the rules for which the IRS has jurisdiction. He described the planned IRS survey/questionnaire as a form of "self-audit."

Treasury Benefits Tax Counsel W. Thomas Reeder followed by stating Treasury hoped to provide State and local government stakeholders more opportunities for input in its current tri-agency effort with the Labor Department and the Pension Benefit Guaranty Corporation to provide guidance on the definition of a "governmental plan" under tax code Section 414(d). He made assurances that Treasury would be taking extra steps to allow comments to be received from State and local government stakeholders, including advance notice of proposed rulemaking to get initial comments, followed by proposed regulations, and then the opportunity for further comments before the final regulations were issued.

Representatives from the Governmental Accountability Office (GAO) also participated in the roundtable, sharing their findings in studying state and local government employee retirement system financing, benefit protections and investing. The GAO reports have generally found public plans in good condition in these areas.

The public sector panelists, including Peter Mixon on behalf of CalPERS, relayed their appreciation for the roundtable and what they hoped would be the beginning of an ongoing, constructive dialogue with federal officials. They outlined key characteristics within the diverse public plan community, including State and local governance processes, benefit protections (even in extreme situations, such as municipal bankruptcy), public employee representation and transparency in public plans, and the fact that IRS regulation must accommodate both the inherent property rights with regard to public plan benefits as well as the legislative process required to make changes.

The consistent message was that the State and local government community hoped it could work cooperatively with Treasury and IRS in an orderly process to establish clear and appropriate guidelines for public plans prior to enforcement efforts being initiated. The goal was to convince the IRS to change its current questionnaire approach and replace it with a process that is based on more accurate information than would otherwise result from their survey, and which would serve as a sound basis for more detailed written guidance.

Commissioner Miller nonetheless stated his strong desire to go forward with the IRS plans to distribute the questionnaire. He promised it had been significantly altered from the original draft shared with public plan representatives, which he admitted was “not ready for prime time.” Even when several roundtable participants as well as Congressman Pomeroy suggested that the Service should get feedback on the new draft before distributing it to plans, Miller stated that the IRS nevertheless strongly wished to get the questionnaire out to the pilot group, while simultaneously making the new draft public and available for comment.

Congressman Pomeroy strongly urged him to reconsider his approach and specifically suggested that a small working group be formed to work with the IRS to review the questionnaire. Congressman Rangel’s staff representative also indicated that she hoped she would be able to report back to the Chairman that some progress had been made instead of simply maintaining the status quo.

Subsequent to the meeting, suggestions for a schedule for such consultations was developed and forwarded to Mr. Pomeroy’s office for their consideration and presentation to the IRS. While it focused on the questionnaire, it was designed to hopefully provide the basis for an ongoing working group/task force to engage the IRS and Treasury in a process of developing additional guidance and other compliance assistance as the predicate for any subsequent IRS enforcement efforts.

### **Action Pending on 401(k) Debit Cards**

Congress may move to ban 401(k) debit cards, new products that allow participants to borrow up to \$50,000 from their accounts under the promise to repay, much like a credit card. Although not a common product, most retirement policy experts believe the cards are dangerous in that they facilitate taking money out of an account when policy should be emphasizing more and better ways to put money in.

Christian Weller, a professor in the University of Massachusetts Boston Department of Public Policy and Public Affairs, called 401(k) debit cards “the subprime loan version of the 401(k) world.” The fact that the cards are being marketed to younger people is also troubling to Weller, as retirement savings benefit most when larger amounts are put into savings vehicles earlier. On the other side, Edward Ferrigno, Vice President of The Profit Sharing/401(k) Council of America, said the perception of the problem is overblown and that a ban would “Slay [a] dragon that doesn’t exist.” Nonetheless, the Securities and Exchange Commission (SEC) has offered warnings about the cards, informing holders that “More akin to a traditional credit card, you must repay the money you withdraw using the card, along with fees and interest—or you may incur substantial penalties.”

Chairman of the Senate Banking Subcommittee on Housing Chuck Schumer (D-NY) offered S. 3278 to ban 401(k) debit cards. Schumer’s introductory statement justified the legislation by saying, “After retreating over the last few years, companies looking to raid Americans’ 401(k) accounts are making a comeback. This legislation will protect people’s nest eggs from companies peddling debit cards that can deplete retirement savings with a simple swipe.” The bill also caps the number of outstanding loans a participant may have to himself at three, which critics dismiss as excessive. The bill may be bundled with another measure that facilitates automatic enrollment in retirement plans.

### **House Passes New Commodities Legislation; Ban on Institutional Investors Not Included**

Some Members of Congress continue to believe that excessive speculation in the oil futures market has been to blame for high gasoline prices throughout most of the summer. Nevertheless, it appeared that a push to impose an absolute ban on institutional investor participation in the commodities futures markets was losing its initial appeal earlier in July, when Senator Joseph Lieberman (I-CT) decided not to include the approach in his legislative proposals. However, as the August recess neared, the House leadership began pressing again for something that members could point to that evidenced their concern for consumer difficulties at the gas pump.

Consequently, in the last days of July, a prohibition on institutional investor “speculation” in the commodities markets was proposed as part of a comprehensive bill dealing with the Commodity Futures Trading Commission (CFTC). In effect, it would have amounted to a ban on pension fund investments in commodities. However, due in part to concerns raised by public funds, this provision was successfully stripped from the bill during the Agriculture

Committee's mark-up of the legislation. Nevertheless, significant restrictions on institutional investor trading involving interest rate swaps, equity derivatives, and other derivative transactions were included that many viewed as potentially amounting to a "de facto" ban. But the House failed to pass the legislation on July 30<sup>th</sup> under an expedited suspension process requiring a two-thirds vote, and when it became clear that no legislation in this area would be capable of being passed in the Senate, the House left for its summer break without further action on the measure.

After Congress returned in September, the fall in the price of oil and the looming credit crunch appeared to distract attention from the legislation. Nevertheless, Congress eventually returned to the issue when, in mid September, the House decided to take up energy legislation. Initially, it appeared that provisions dealing with commodities trading would be included in the energy bill, but a deal was reached where the commodity legislation would be dealt with separately.

Thus, on September 18, the House passed the "Commodity Markets Transparency and Accountability Act," H.R. 6604, by a substantial margin of 283 to 133. Under the legislation, the CFTC would be prohibited from allowing a foreign board of trade to provide its members or participants located in the U.S. with access to the electronic trading and order matching system for energy and agricultural commodities, unless the board of the foreign board sets transparency requirements similar to those on U.S. exchanges.

The bill would also require the CFTC to establish limits on the positions that may be held by a single person with respect to the future sale of agriculture and energy commodities contracts traded on the open market, either through contract market, a derivatives transaction facility, or an electronic trading facility.

Within 150 days of enactment, the CFTC would also be directed to assemble and convene a 'Position Limit Agricultural Advisory Group' and a 'Position Limit Energy Group.' These groups would consist of members from commercial short hedgers, commercial long-hedgers, non-commercial participants in futures and designated contract markets, and would submit advisory recommendations regarding position limits, and whether the limits should be administered by the CFTC or by the registered entity on which the commodity is listed.

The strong support for the bill reflects how sensitive Members of Congress continue to be to the need to respond to the high cost of energy. However, the Senate has yet to take up the measure, and the White House has indicated that were the bill to be sent to the President, he would veto it, saying that it "offers

poorly targeted short-term measures that do nothing to address the fundamentals of supply and demand that bear the primary responsibility for current high energy prices” and that it would “hurt the competitiveness of American futures markets.”

Therefore, for the present, it appears that Federal efforts to place investment restrictions on pension plans in the area of commodities have been successfully avoided. However, the effort to do so in the House Agriculture Committee came very close to succeeding. Given the current economic unrest, the likelihood of major changes to the financial regulatory structure in the next Congress, and a new occupant in the White House in 2009, institutional investors will need to pay close attention to ensure that “reform” in this area does not result in unnecessary limits or prohibitions on large investors.

### **SEC Finalizes Short Selling Rule**

The Securities and Exchange Commission (SEC) targeted “abusive” short selling with a new rule finalized September 17. The rule permanently bans naked short selling, characterized as “unlawful manipulation” of the markets by regulators. Short sellers will also have to truthfully inform their broker-dealers of their intentions in shorting a stock in regards actual delivery of that stock.

As the Commission release explains: “In an ordinary short sale, the short seller borrows a stock and sells it, with the understanding that the loan must be repaid by buying the stock in the market (hopefully at a lower price). But in an abusive naked short transaction, the seller doesn't actually borrow the stock, and fails to deliver it to the buyer. For this reason, naked shorting can allow manipulators to force prices down far lower than would be possible in legitimate short-selling conditions.”

## **Related National and Industry News**

### **DB Plans Much More Cost-Efficient Than DC, Report Finds**

According to a new study by the National Institute on Retirement Security (NIRS), a defined benefit pension plan can provide the same retirement income as a defined contribution plan at just over half the cost. Governing magazine calls the report a “401(k) eye-opener.” Beth Almeida, NIRS’ Executive Director, says that the analysis “is a myth buster of the conventional wisdom on the cost of retirement plans.”



A defined benefit pension can provide the same retirement income as a defined contribution plan at just over half the cost, according to a new NIRS study released in August entitled "Better Bang for the Buck." According to the study, in order to fund a retirement benefit that replaces 53 percent of final salary, a DC plan would require 22.9 percent of payroll, whereas a DB pension would need just 12.5 percent. This means that the total cost of providing a monthly benefit of \$2,200 to a worker who retires at 62 would be \$355,000 for a DB pension and \$550,000 for a DC plan.

The savings, according to the report, come from the ability of DB plans to do three things: 1) pool longevity risks; 2) maintain a consistent investment approach and ride out bear markets; and 3) get better returns because of lower fees and professional management.

Ms. Almeida, an author of the report, said "The analysis clearly indicates that the qualities inherent in DB plans – particularly, the pooling of risks and assets – fuel their fiscal efficiency. Importantly, the report provides a new lens for policymakers, employers and employees, who are struggling to ensure adequate retirement income with the fewest dollars possible."

NIRS is a not-for-profit organization whose purpose is to conduct research and education programs regarding the traditional pension system in the United States. It was formed by National Council on Teacher Retirement (NCTR), National Association of State Retirement Administrators (NASRA) and the Council of Institutional Investors (CII) in 2007 to help offset the "research" and other reports prepared by opponents of DB pensions in support of their efforts to convert public systems to a defined contribution model.

During this time of economic turmoil, millions of Americans are fearful for their retirement security as they have watched their 401(k) balances decline. The new NIRS study shows that not only can DB plans help assure a reliable, dependable retirement for their participants that they will not outlive, but DB plans can do so at a lower cost to employers as well. Not a bad model to emulate, I'd say.

### **Conventions, Candidates, Largely Silent on Retirement Needs**

The national party conventions barely mentioned retirement issues during the two week break from legislative business for the political rallies in Minneapolis and Denver and have not figured in the debates held to date. Although several convention speakers touted the importance of a "secure retirement," details remained where they had been, buried on the websites of the candidates.

The McCain website does not list retirement among its issue areas. The Obama website groups retirement issues under Seniors and Social Security, where a variety of savings incentives are described. These initiatives include reforming bankruptcy laws to elevate the status of pension participants above banks; more disclosure of pension investments; eliminating income taxes on seniors making less than \$50,000 per year; automatic enrollment for workplace pension plans; and creating a onetime matching program where the government would match up to half of the first \$1,000 in retirement savings opened by a person making less than \$75,000.

Significant new information on the candidates' plans for retirement security may still arise in the remaining debates in October but both campaigns seem to have shifted to larger themes. The economy and the war remain the top polling issues among the electorate, and those topics will likely see even more attention as the campaign draws to a close.

### **Surveys Say: Americans Unprepared for Retirement**

An Ernst & Young study for Americans for a Secure Retirement (ASR) suggests that retirees even 7 years out from retirement could face a 24-37% decrease in their living standard if they want to avoid outliving their assets, even if they make 60-71% of their final wages in retirement. None of the studies explicitly examined whether the problems stem from the defined contribution crazed environment of current policy, although those with traditional pensions almost always fare better.

The heart of the problem is an old one: people are not saving enough. Joe Reali, Chairman of ASR, notes that most people's "nest egg is too small to make up that difference" in income "and, for those who do not have a defined benefit plan, their nest egg is way too small....Those close to retirement are likely to have a substantial reduction in their standard of living," perhaps up to half, according to Reali. "A lot of people are tremendously underprepared for retirement," he said. The group estimates that more than half of retirees will blow through their assets if they do not dramatically cut their standard of living, and those depending on Social Security as their only retirement income have a 90% chance of doing so.

This study dovetails with a recent one from Hewitt Associates that found only 19% of those surveyed were saving enough to meet 100% of the firm's estimate of their retirement income needs. And this survey was among 2 million employees at the 72 largest U.S. companies, ignoring the millions of people employed by companies that do not or cannot offer any help in facilitating retirement savings.

That problem fits with another found by MetLife's Retirement Income IQ Test: education. According to this research, 43% of those asked believed they could draw down 10% of their savings each year while preserving their principal and about 70% believe they can draw down far more than experts believe possible to preserve assets for the long haul. "People underestimate how long they are going to live, and they overestimate how much they can draw down in retirement," says MetLife Vice President Roberta Rafaloff. Most people do not calculate for inflation, or contemplate post-retirement medical expenses.

Employers can do more to educate workers about the important facts behind retirement, such as expected lifetime and how much one should bank to preserve one's living standard.

### **WaMu Failure Largest in History**

Washington Mutual (WaMu) became the latest casualty of bad loans and was seized by the Office of Thrift Supervision on September 25, becoming the largest depository failure in U.S. history. The Feds almost instantly flipped the thrift to JP Morgan Chase for \$2 billion. The buyer assumes \$176 billion in mortgage assets, writing them down by \$32 billion and paying the Federal Deposit Insurance Corporation a one-time fee of \$2 billion.

Like other banking and Wall Street cadavers, WaMu found itself on the wrong side of a change in its credit rating based on the quality of mortgage assets it held. The firm specialized in option ARMs and was a large subprime lender.